
The Maine Partnership Bank



Promote a strong and resilient local financial system
by partnering with Maine community institutions.

By Jared Gardner

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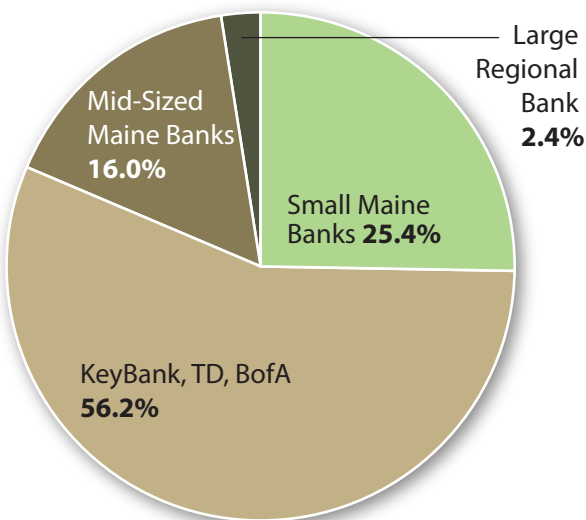
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INTRODUCTION

The national and international banking systems facilitate the extraction of wealth from Maine communities. The state of Maine has the resources to slow this economic leakage and strengthen its local financial sector for the benefit of the state's economy by creating the Maine Partnership Bank. This institution would keep a larger portion of state deposits in-state and facilitate more loans through Maine-owned financial institutions. Profits earned could fund the expansion of economic development tools administered by the Finance Authority of Maine, further improving access to capital in Maine communities.

Share of Bank Deposits in Maine



Source: FDIC data, as of December 2012

The banking landscape in Maine is heavily consolidated, with over 56% of bank deposits controlled by three Wall Street and multinational banks that do scant small business, family farm, or marine resource lending in Maine. Because Toronto-Dominion (TD), KeyBank, and Bank of America dominate such a large portion of Maine's banking system, many loans (and profits made from the interest Maine residents pay) leak out of state.

Meanwhile, the majority of Maine public funds are invested out of state, where non-Maine financial institutions use them to maximize their own profits. It is not sufficient, or even possible, to simply pull these deposits back into Maine without also addressing ways to safely increase lending

Being local means decision-makers are in the communities they work in. Big banks, especially rural branches of Wall Street banks, often forward credit decisions to remote executives with little or no knowledge of that specific community or the local economic factors.

by Maine-owned institutions. The Maine Partnership Bank seeks to address these issues.

Senate LD 1078 establishes a Task Force on the Creation of a State of Maine Partnership Bank. This task force is intentionally focused on a very specific vision for a Maine Partnership Bank that is designed to safely

and efficiently partner with local financial institutions to slow economic leakage and market consolidation by national and international banks. It seeks to complement the mission and existing resources in the state, especially those of the Finance Authority of Maine, and to avoid costly, risky, and inappropriate features sought in “State Bank” proposals in other states.

WHY COMMUNITY-BASED FINANCIAL INSTITUTIONS?

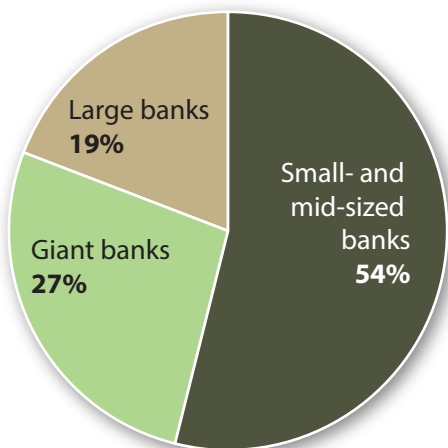
Federal decisions to bail out “Too Big to Fail” banks have disproportionately hurt community banks. Despite the playing field tilted against them, local financial institutions have largely weathered the storm and continue to benefit local communities in many ways, including having local decision-makers, more focus on small business, and more profits staying in local communities.

By nature of being rooted in our communities, local financial institutions

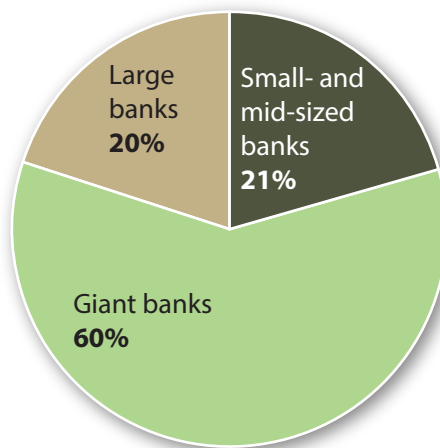
bring a number of benefits. First, being local means decision-makers are in the communities they work in. Big banks, especially rural branches of Wall Street banks, often forward credit decisions to remote executives with little or no knowledge of that specific community or the local economic factors.

Larger commercial banks rely on standardized lending formulas, while community banks have greater knowledge of the borrower in their community, as well

Share of Small Business Lending



Share of Bank Assets



Small banks < \$1 billion in assets; mid-sized banks = \$1 billion-\$10 billion; large banks = \$10 billion-\$100 billion; giant banks > \$100 billion.

Source: Institute for Local Self-Reliance, and Federal Deposit Insurance Corporation data, 2nd quarter 2012. (Mitchell, Oct 18, 2012)

as a better on-the-ground understanding of local market conditions (Bernanke, 2011). Community financial institutions are more accessible and decision-makers can meet face-to-face with potential borrowers. What this translates to is a better knowledge of the local economy and a more individualized approach to making loans, and thus more likelihood of a community bank lending to a small business (Shane, 2013).

They therefore are able to justify loan decisions based on a fuller picture of the overall credit quality of the business, including deeper analysis of two important credit criteria: borrowers' character and the conditions unique to borrowers' requests (Bernanke, 2011). This, in turn, means a wider range of loans can be made. In fact, throughout the recession as big banks pulled back from small business lending (Mitchell, 2012), community banks increased small business lending (Perman, 2009). Even as big banks were credited with increasing their

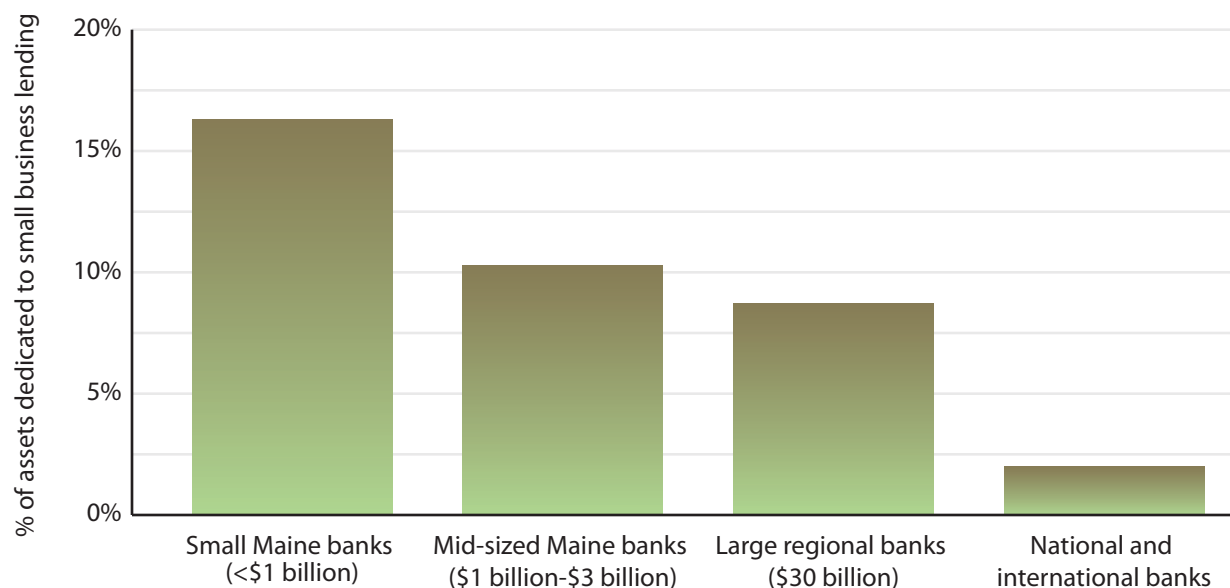
lending approval rates to 14.9% of small business applicants — the highest they've seen in 2012 — community banks improved their approval rates to nearly 50% (Browdie, 2013).

The notion that community banks favor small businesses holds up when we look at all lending across the U.S. What we see is a fairly consistent picture, with small- and medium-size banks doing the majority of small business lending, and with a minority of banking assets.

Large and giant banks controlled 80% of bank assets in the U.S. in 2012, yet held only 46% of small business loans. Meanwhile, small and medium banks held 21% of banking assets and 54% of small business loans (Mitchell, Oct. 2012).

This pattern holds up in Maine, as well. Small- and mid-sized community banks have much higher percentages of their assets in

Small Business Lending by Bank Category



Source: FDIC data as of 12/2012

Not only is small business lending a miniscule part of Wall Street banks' assets, but lending in general tends to be low. Rather, Wall Street banks engage in speculative trading and investment banking, activities that at times generate high returns and at other times can disrupt the global economy.

small business lending than do large banks, especially the national and international banks.

When we look at what banks do with our deposits, more alarming trends emerge. Not only is small business lending a miniscule part of Wall Street banks' assets, but lending in general tends to be low. Rather, Wall Street banks engage in speculative trading and

investment banking, activities that at times generate high returns and at other times can disrupt the global economy. (Mitchell, 2010). And, if this was not enough, research shows that the average local financial institution provides the same services as Wall Street Banks, and does so more efficiently. Community banks and credit unions provide, on average, lower interest rates, better terms, and lower fees (Mitchell, Nov. 2012).

HOW DOES THE STATE FACTOR IN?

The State of Maine has significant resources in terms of long-term assets (pension funds, economic development loan funds, etc.), but also a sizeable amount of short-term deposits in the \$400 million-\$700 million Treasurer's Pooled Cash Account. Better than many states, Maine has a significant portion of its state deposits in locally headquartered banks (23% as of November 2012).

That said, the majority of these public deposits still leave the state, including \$153 million (or 33%) to national and international banks such as TD, Bank of America, US Bank, Goldman Sachs, and Citigroup. Typically, such investments are

justified in terms of their higher yield, though these corporations returned a significantly lower yield (0.01%-0.15%) than the entire portfolio average of 0.29% (Maine State Treasurer-Pooled Cash Account December 2012).

These public funds represent a significant amount of liquidity that these out-of-state financial institutions are using to their own benefit. A Maine Partnership Bank aims to facilitate such funds to stay in-state, where they can be leveraged in partnership with the local financial sector as it rebuilds more of its market share for the benefit of the Maine economy.

WHAT CAN A MAINE PARTNERSHIP BANK DO?

The partnership bank model being proposed for study with Senate LD 1078 would be a relatively small and focused entity. It would require a significant but relatively small amount of investment capital to start, say \$15 million-\$25 million. Such a bank could then accept deposits of \$150 million-\$250 million.

This would not be your typical retail bank. There would be no branches, no ATMs, no checking accounts or other retail banking services. It would not originate loans directly to businesses and residents. Rather, it would be a wholesale bank that interfaced primarily with the community banking sector, simply buying, holding, and selling loans originated by local financial institutions. In particular, it would focus on two primary types of loans — commercial loan participations and high-quality residential mortgages.

Loan participations are critical, especially for smaller local financial institutions, because their lending can be capped in three ways — loan size, loans to a single borrower, or loans in a given sector (commercial real estate or farmland, etc.). For instance, a small community bank may reach its lending limit

with a medium-size farmer or commercial business. Moving ahead would require the partnership of more than one institution. In such cases, one community bank would originate the loan, while one or more contribute funds to finance the transaction. The originating lender administers, or “services,” the monthly payments and distributes the proportionate amount to the other lenders. In the event that something goes wrong, the lead bank works out issues with the borrower and, in the event of default, all participants are paid according to the proportion they invested.

With today’s economic climate, community banks are unable to make as many loans as they were prior to the economic crisis triggered by Wall Street banks. Thus, when a larger, credit-worthy opportunity presents itself, small community banks can quickly find one or two partners to contribute. However, this has not always been possible. Having an additional partner in the state that is dedicated to facilitating loan participations will be a valuable resource in the near future from the perspective of small Maine community banks.

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From the perspective of the state, loan participations are fairly efficient investments, as it falls on community banks to take the lead. The basic pattern begins with a borrower seeking a loan from a local community bank. It then evaluates the loan application and, if deemed credit-worthy, determines how much of the loan it can take on. The community bank then submits an application for a loan participation to the Partnership Bank, which would review the application and documentation, making sure it meets the credit criteria. Once the Partnership Bank has committed to its portion, the community bank completes the loan transaction, facilitating not only the loan closing, but also administering, or “servicing,” the loan for its duration.

Each time the community bank receives payment, it forwards to the Partnership Bank its portion of the payment. If anything goes wrong with the loan, the community bank interfaces with the borrower to find a workable solution or, in the event of default, liquidates. The Partnership Bank shares in “first position” according to the proportion each bank has invested in the loan. This helps protect the Partnership Bank while giving the state the ability to invest public funds in “bankable” local businesses and farms, producing returns to the state, community bank, and broader community.

A second category of investments for the proposed Maine Partnership Bank is in high-quality residential mortgages. Maine community banks tend to do large volumes of residential mortgages and keep them on their books, and they have a strong track record of issuing sound mortgages. However, there are times community banks look to sell their residential mortgages to make more residential loans. These include government-guaranteed mortgages like Federal Housing

Administration (FHA) and Veterans Affairs (VA) loans. This is in contrast to the way Wall Street builds a business model around making loans as fast as possible and then selling them as investment securities to hide their risk. The faster the lenders can originate and sell these loans (and any associated risks to themselves), the more money they can make. This, combined with relaxed (or no) lending standards, was a recipe for disaster.

But not all lenders operate the same. As the FDIC reported in a special foreclosure edition of its Supervisory Insights publication, “community banks fared far better than larger institutions in terms of delinquency rates on residential mortgage loans and have undertaken far fewer foreclosures” (FDIC, 2011). The primary reason for this is that community banks underwrote these loans for the purpose of keeping them long-term, and, when they did sell them, they followed their standardized procedures rather than taking shortcuts, unlike, as the report outlines, Wall Street banks.

That said, because of historically low residential rates, it is often difficult for community banks and credit unions to keep large volumes of these loans on their books. These include FHA and VA mortgages that are government-guaranteed. Such high-quality and low-risk (guaranteed) mortgages comprise a good portion of a loan portfolio for a partnership bank. Local financial lenders appreciate a consistent and quality source to sell such loans. Many have experienced firsthand that some of the larger Wall Street banks that often end up servicing loans that are sold on the secondary market try to market to these customers with teaser rates or other financial products.

WHAT IS NEEDED TO START A PARTNERSHIP BANK, AND HOW ARE SAFETY, LIQUIDITY AND RETURN ADDRESSED?

In terms of launching a bank, there are three categories to focus on: investment capital, deposits, and loans. Investment capital is needed for all the upfront costs associated with starting this new business. In addition, this capital serves another important role in facilitating the ability to accept deposits and lend a portion of these out. Banks are in the business of safekeeping depositors' funds, lending a portion of these out at a higher rate than they pay depositors, and making a profit on the difference after all expenses. If funds are lost with a loan that defaults, the bank still owes the depositors their funds back. In order to cover this loss, the bank would dip into its equity or the investment capital of the bank.

This investment capital is a category that can be solved in a variety of ways. The Legislature can deploy funds it identifies as appropriate for investing in Maine's economy. Particular long-term investment funds that the state manages are also a potential. Third, bond issuances — or “invest in Maine” bonds — are another possibility. Once investment capital is secured, the Partnership Bank can accept funds and begin buying loans and loan participations.

The second category is deposits. These would come from a portion of the state's short-term fund, to be discussed at greater length below. These deposits would be used to partner with community banks to help them make more loans, which is the third category.

Accepting deposits, especially public funds, requires the ability to manage for liquidity, safety and return. This is the crux of banking

and cannot be overemphasized. It is thusly vital to have an experienced banker running the Maine Partnership Bank.

Safety

Quality, solid, conservative banks are not really in the risk-taking business. When they lend, they seek security in the form of collateral, whether that be through low enough loan-to-value ratios that they can cover any losses in the event of the need to liquidate a defaulting borrower's collateral, or in the form of government guarantees, as with FHA, VA, Small Business Administration (SBA), or Farm Service Agency (FSA) loan guarantees that limit the losses for the originating lender.

Another area of safety critical in discussions about the state acting as a bank is safety of deposits. Most people are familiar with FDIC or NCUA deposit insurance. This federal insurance protects individual depositors up to \$250,000 in the event that the institution fails. Insurance premiums are costs banks must factor in to their cost of operations. Submitting to the FDIC and NCUA for insurance subjects the institution to their oversight and discretion regarding shutting down the institution. In the event of the state depositing its funds in its own bank, the single depositor (State) would have very minimal coverage from FDIC (\$250,000, perhaps multiplied a few times by each unique state depositing entity), but would incur costs on these deposits. Since deposit insurance is to protect the depositors (and would have minimal effect for a state), it is more important that the state

run a sound, conservative bank in order to protect its investments. This translates into very conservative practices and a clear and strong firewall that separates from its banking operations the traditional “economic development” programs that carry higher-than-average risk. Economic development is best done with appropriated, and not leveraged, funds.

Liquidity

When short-term deposits are used to purchase loans you immediately have a mismatch in terms of maturity — short term deposits are needed in coming months while loans will be repaid over years.

One important ratio to ease term mismatch is loans-to-deposit ratios that leave a portion of funds liquid and available. Banks can analyze their core deposits and determine what level will be needed at any given time during the year. States (and cities and counties) are unique in that there are cyclical times where they run their accounts down to zero shortly before very large influxes of tax receipts. It will be up to banking professionals running the partnership bank to adequately assess these fluctuations, but as a policy issue it may be advisable to consider different short term funds that have different cycles — local government funds, public employee retirement funds awaiting disbursement, state government funds, etc.

An important tool banks use are lines of credit from the Federal Reserve or Federal Home Loan Bank or other financial institutions. During the short periods where liquid funds are not available (having been used to purchase loans), the bank can borrow short term. There are costs associated with this — interest costs for borrowing (similar to interest payments

made to depositors (i.e. the State) as well as administration costs to manage this daily balancing of the books.

Return

Returns in banking are measured differently than for other lending entities, like revolving loan funds. While both make loans in relatively similar interest rate ranges, a revolving loan fund’s return on assets is equivalent to its return on invested capital, as with a \$100 million fund having \$100 million of invested capital. If loaned out at an average of 6%, the return might be around 4%-5%. A bank, on the other hand, has investment capital, then accepts deposits (which are liabilities to the bank since it must keep them safe and eventually pay them back to the borrower) and makes or buys loans (which are assets to the bank, as they provide income and can be sold).

The investment capital, or equity (assets minus liabilities), is what the bank taps into when any deficits occur when liquidating collateral for loan losses. Conversely, retaining profits grows equity, allowing the bank to make more loans. The assets/loans may similarly average 6%, but there are higher costs on the bank’s liabilities (paying yield to depositors, costs of maintaining liquidity, higher costs of compliance/regulation, etc.). Thus, the net return on assets may only reach 1%-1.5%.

Since banks must manage their assets to limit their losses (conservative and “boring” banking), they can leverage deposits against their equity, often referenced as roughly a 10-1 leverage ratio. Thus, for a bank, a 1%-1.5% return on assets translates to a 10%-15% return on equity. This is the financial benefit of banking, but it also means that any losses are leveraged losses — a \$1 million

loss eats up \$1 million of equity, reducing lending capacity by \$10 million.

In thinking about return, it is important to circle back to costs of liquidity. While it is true that banks are actually “borrowing” money from depositors, and that banks can and do borrow short-term to balance their books, these interest rates are variable and subject to change much faster than long-term, fixed-rate loans. Thus, if a bank has a loan portfolio at today’s low rates (say, averaging 5%-6% note rates), and, over the next few years, short-term rates (on market

yields for deposits, or “overnight funds,” to balance books) rise a mere 1% or more, then the very thin return-on-assets margin of 1%-1.5% can be quickly wiped out. This risk is termed “interest rate risk” and should be taken very seriously when thinking about a partnership bank that leverages public funds. Institutions like the Federal Home Loan Bank system help protect banks against such interest rate risks, another reason that a successful Partnership Bank should be run like a real bank, although it would have very limited functions.

HOW WOULD IT RELATE TO EXISTING AGENCIES LIKE FAME AND THE TREASURER'S CASH POOL?

Interface with FAME

The Finance Authority of Maine (FAME) is the main state agency that lends in-state. The purpose of FAME is “to stimulate a larger flow of private investment funds from banks [and other financial institutions] to help finance ... industrial, manufacturing, recreational, fishing, agriculture, business and natural resource enterprises and eligible projects of the State and its political subdivisions; and to increase the access of smaller business and veterans to financing at reasonable terms and rates” (MRS Title 10, Section 962). FAME has some good programs for economic development (extending credit where conventional lenders are unable to) primarily in loan insurance programs, but it lacks tools that a Partnership Bank would have to stimulate more local lending while also preventing interest paid on these loans from leaking out-of-state.

FAME is already established and operational, plus it has a track record and existing

relationships with community banks and credit unions across the state. One idea worthy of exploring in the task force is the potential strength of locating a Partnership Bank under its existing Board. The FAME Board is composed of 15 voting members. Three members appointed by the Governor must include a CPA, attorney, and commercial banker. Additionally, nine at-large members appointed by the Governor must include two veterans, and two natural resource experts or lenders, one with student financing experience and one with experience in the higher education system. The last three members are to include the Commissioner on Economic and Community Development; a Natural Resources Commissioner designated by the Governor from either the Department of Agriculture, Conservation and Forestry, or the Department of Marine Resources; and the State Treasurer. Such a Board would be qualified to hire an experienced banking team to run the Partnership Bank.

Treasurer's Cash Pool

The Office of the State Treasurer manages the state's cash transactions. Funds that are not needed to pay the state's expenses are invested in short-term investments or deposits. As originally conceived, a Maine Partnership Bank would not handle banking services for the state, such as the massive yearly volume of check transactions or electronic fund transfers. Rather, the Maine Partnership Bank would be one option among the current options for the Treasurer to deposit funds into. Such funds would not be long-term investments in bank capital, but would be treated like a deposit in a normal financial institution, with the Partnership Bank managing its operations to ensure the state is able to withdraw these funds on the schedule it needs to in order to pay the state's obligations. Given the Partnership Bank's focus of promoting a strong and resilient local financial system, it would make sense that the Treasurer's commitment to banking local not change, but that funds invested in national and Wall Street banks be divested and deposited in the Maine Partnership Bank so that it has funds to partner with local financial institutions.

In addition, with regard to assisting in the financing of higher education, FAME is already empowered to "borrow money or otherwise obtain credit in its own name" and can "exercise all powers of a lender or creditor" (MRS Title 20-A, §11417). Also, FAME has been tasked to "take all actions necessary to implement and administer a student loan secondary market" (MRS Title 10, §969-A). Such precedent should be explored in terms of how best to set up a Maine Partnership Bank within the existing laws and infrastructure in Maine.

How Is this Different than Other 'State Bank' Proposals?

More than a dozen states have seen legislation to study a state bank or to actually enact one. No state since North Dakota in 1919 has passed similar legislation. Many state bank proposals have sought to emulate the Bank of North Dakota (BND). BND is quite an anomaly in that it was set up so long ago and many changes have happened in the financial system since then. For example, BND handles check clearing for North Dakota banks that want it, a role the Federal Reserve branches do for banks elsewhere. BND provides financing for infrastructure as well as administers the state's economic development programs. While having a centralized entity manage all of these components can be efficient, most states already have unique entities that have evolved to meet their local needs.

The intent with the Maine Partnership Bank concept is to specifically partner with Maine-owned financial institutions through the creation of a vehicle whereby more public deposits can be kept in-state and more in-state investments can be made. Such a focus has become perhaps the most profitable feature of BND, which has shifted most of its focus to developing a portfolio of commercial and agricultural loan participations and buying residential mortgages from community banks. This model has proven successful for BND, as it has averaged 1.6% return on assets and 22% return on equity over the past decade.

While BND does administer economic development programs for North Dakota, funding comes from legislatively appropriated funds. This is an important distinction, because state bank campaigns in other states have emphasized the extension

The proposal to study a Main Partnership Bank seeks to address different issues than state bank campaigns in other states have focused on. ... The Maine Partnership Bank is premised on the reality that national and international banks control a large and growing percentage of Maine's financial sector and that this domination by out-of-state entities leads to the extraction of wealth from Maine communities rather than investment.

of credit to those deemed uncredit-worthy by their local banks. Trying to fill such lending gaps with a state bank's own resources would mean taking higher risks with public deposits. That said, because BND returns a portion of profits to the state each year, it is essentially funding economic development tools like loan guarantees and subsidized interest rates so that North Dakotans continue to have greater access to credit. Certainly there is some degree of efficiency with BND managing the boring side of buying loan participations and residential mortgages as well as the economic development side, but since entities like FAME already have a track record in economic development for Maine, it is not necessary to try and duplicate this with a Partnership Bank.

Other state bank proposals have focused on saving their state money on banking services, as well as generating significant returns to plug budget holes. Providing

banking services requires the capacity and sophistication to handle large volumes of transactions. While states incur sizeable costs to have large financial institutions contract for these services, it seems unlikely that a state entity, especially a start-up bank, could justify the up-front costs in terms of systems, software and personnel.

In terms of generating revenues for the state, we must keep in mind that the larger projected returns on equity, such as BND's average 22% returns, are on a relatively small investment. In BND's case for 2011, it had net earnings of \$70 million on equity totaling \$400 million, representing a lower-than-average ROE of 17.6% and ROA of 1.3%. It would take many years to recoup the initial startup costs, plus a significant amount of time reinvesting earnings to organically grow a Maine Partnership Bank to such a size. Thus, both the ideas of saving the state large sums of money on banking services and

earning significant returns to buffer general funds seem like conversations for distant days.

That said, some level of profits is to be expected, and, perhaps, the best use for such profits after incrementally growing the Partnership Bank toward an optimal size would be to plow these funds right back into economic development programs for FAME. By slowing economic leakage and growing economic development programs Maine could slowly realize more robust tax receipts for a stable and improving economy.

In summary, the proposal to study a Maine Partnership Bank seeks to address different issues than state bank campaigns in other states have focused on. In line with the Federal Reserve Bank of Boston's premise that government should play a role when the market performs suboptimally, the Maine Partnership Bank is premised on the reality that national and international banks control a large and growing percentage of Maine's financial sector and that this domination by out-of-state entities leads to the extraction of wealth from Maine communities rather than

investment. Similarly, Maine public funds are invested out-of-state and are used for profit maximization by non-Maine financial entities. The intent of a Maine Partnership Bank is to slow economic leakage and specifically support the community-banking sector so that loans to Maine businesses and residents, and the interest paid, circulate in-state.

In its design, the Maine Partnership Bank seeks to specifically partner with Maine community financial institutions, not to compete with them. These local financial institutions provide more consistent access to capital for Maine businesses and farmers, and profits earned by local financial institutions stay in-state. Rather than taking on additional risk by extending credit where other institutions will not lend, the Maine Partnership Bank is designed to buy and hold high-quality loans originated by local institutions so that these institutions can make more loans. By keeping more banking-related profits in-state, more wealth stays in Maine communities and the profits earned by the Maine Partnership Bank can fund incremental expansions of economic development tools administered by FAME.

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MPA's purpose is to bring individuals and organizations together to realize shared goals. We focus on leadership development to increase the number of citizen leaders prepared to work for positive social change.

We are known for our ability to do grassroots organizing and education that reaches more than 100,000 Mainers each year with direct personal contact and quality leadership development work that has yielded dozens of leaders and staff for MPA and other organizations. MPA was founded in 1982 (and officially incorporated in 1983) in the Lewiston/Auburn area with a focus on housing, rent and utility rate reform issues. In 1984, our sister organization, the Maine People's Resource Center, was created.

MPA has three main chapters, in Lewiston, Portland and Bangor, where members meet each month to work together to advance the issues they care about.

www.MAINEPEOPLESALLIANCE.org



The Alliance for a Just Society's mission is to execute regional and national campaigns and build strong state affiliate organizations and partnerships that address economic, racial, and social inequities.

We believe that class, race and gender are the most fundamental divisions in society. We acknowledge that none of these dividing forces can be addressed without working to address all of them simultaneously. The struggle for social justice requires a strong, broad base to defend advances made toward economic justice and, in turn, generate increased power to sustain social change. All of this work depends on developing a core of leaders, educating the public, and building the power for fundamental systemic change.

www.ALLIANCEFORAJUSTSOCIETY.org